Introduction to Financial Statement

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Session Objectives

Learn the 5 essential financial statements necessary for planning and monitoring farm profitability.

Basic Financial Framework

Business Abilities & Financial Statements

- Feasibility
- Risk-ability
- Profitability
- Balance Sheet
- Statement of Cash Flows

The Balance Sheet

- Also called the Statement of Net Worth
- Consists of Assets = Liabilities + Owner Equity Owner Equity = Assets - Liabilities
- Must be timed consistently – Typically 12/31/XX
- Should contain both cost and market values
- Deferred tax liabilities
- Equity changes from profit and inflation

The Ohio State University

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Farm Balance Sheets SHOULD Have TWO Columns for Assets

<table>
<thead>
<tr>
<th>Asset</th>
<th>Cost</th>
<th>Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Intermediate</td>
<td>50,000</td>
<td>175,000</td>
</tr>
<tr>
<td>Long term</td>
<td>20,000</td>
<td>325,000</td>
</tr>
<tr>
<td>TOTAL ASSETS</td>
<td>170,000</td>
<td>600,000</td>
</tr>
</tbody>
</table>

Market Value: Lenders Choice

Today’s market values (less selling costs)

Reflects “luck” of investing (inflation/deflation)

What about the deferred income taxes due upon sale?

Cost Value: Accountant’s Choice

Remaining value of the investment, the net book value (cost less accumulated depreciation)

Better reflection of business success

Based upon business decisions rather than inflation or deflation of investments

Assets

Items that are owned and have value.
Divided into three categories
1. Current Assets – assets that will likely be converted to cash within a year.
2. Intermediate Assets – assets with a longer life than one year but less than 10 years
3. Long Term Assets – assets with a long useful life, typically longer than 10 years

Liabilities

Liabilities are financial obligations of the business
Also Divided into three categories
1. Current – due within the current year (next 12 months)
2. Intermediate – length of loan is typically 1-10 years
3. Long-term – length of loan is greater than 10 years

Assets

1. Tractor Current
2. Land Intermediate
3. Crops Long Term
4. Seed
5. Cash in the bank
6. Barn
7. Irrigation equipment
8. Pick-up truck

Liabilities

1. Tractor Current
2. Land Intermediate
3. Crops Long Term
4. Seed
5. Cash in the bank
6. Barn
7. Irrigation equipment
8. Pick-up truck
Liabilities

<table>
<thead>
<tr>
<th>Loan Type</th>
<th>Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pick-up Truck Loan</td>
<td>Current</td>
</tr>
<tr>
<td>Farm Mortgage</td>
<td>Intermediate</td>
</tr>
<tr>
<td>Tractor Loan</td>
<td>Long Term</td>
</tr>
<tr>
<td>Credit Card</td>
<td></td>
</tr>
<tr>
<td>Operating Loan</td>
<td></td>
</tr>
<tr>
<td>New Building Loan</td>
<td></td>
</tr>
<tr>
<td>Lease Payments</td>
<td></td>
</tr>
</tbody>
</table>

Why is EQUITY important?

- Equity...
  - The portion of the business assets contributed by the owners
  - Growth in equity is part of the annual business profit
  - Trends over time help measure the overall health and profitability of the business

Keys to Balance Sheets

1. Complete Balance Sheet the same date each year
2. Inventory (count) assets, include weights
   Use market prices – selling costs for crops and feeder livestock
   Growing crops valued at production cost
3. Accounts receivable includes government payments to be received for past crops
4. Value breeding livestock at conservative value, avoid large year to year changes in value
5. Do not include leased machinery unless shown on a tax depreciation schedule
6. Land values should remain consistent from year to year
   Avoids large net worth gains due to market volatility/inflation. If markets are stable at higher prices slowly increase land values over time.

The Income Statement

A necessary financial form to clearly measure profit or net income

Cash versus accrual basis accounting
   Accrual adjusted income statement combines the cash basis farm records with the inventory changes from the balance sheet

Problems with cash accounting
   Selling down inventory
   Living off depreciation
   Selling capital assets
   Increasing accounts payable
   Refinancing operating losses

Income Statement

Farm Revenue (income)
- Farm Expenses (costs)
= Farm Net Income
+ Non-farm Income
= Total Net Income (before taxes)
- Taxes Paid and Accrued
= Net Income

Adjustments to Farm Income

Not all income is accounted for by cash sales
   Changes in current inventories
   Changes in valuation of current inventories
   Accounts receivable

Changes in market valuation of land, building, machinery and equipment are not included in the income statement unless they are actually sold.
Adjustments to Farm Expenses

Items paid in the current year that will be used in the subsequent year:
- Feed and supply inventories
- Prepaid expenses
- Investments in growing crops
- Accrued interest
- Taxes due
- Accounts payable
- Depreciation (can use tax figure or more realistic number if using rapid depreciation practices for tax management)

Statement of Cash Flows

Different than a cash flow budget
Should be same period of operation as summarized in the balance sheet and income statement
Summarizes how the cash flows into and out of the farm business
Reconciles cash position of beginning and ending balance sheets

Statement of Owner Equity

Reconciles beginning and ending owner equity
Links the Balance Sheets with the Income Statement

Beginning of Year
BALANCE SHEET

End of Year
BALANCE SHEET

STATEMENT OF CASH FLOWS

BEGINNING CASH $157,689

Operating activities
- Net cash income $52,421
- Cash withdrawals $150,000
  $97,579

Investing activities
- Capital sales $63,800
- Capital purchases $97,895
  $34,095

Financing activities
- New borrowing $150,000
- Principal payments $170,999
  $20,999

ENDING CASH $5,016

Statement of Cash Flows

Divided into three groups
- Operating
- Investing
- Financing

Helps separate cash flow from profitability

End of Year
Change in Total Owner Equity

Is calculated on a market value basis

Comes from three sources
- Contributed capital and retained earnings
- Change in personal net worth (when personal assets and net worth is included in the statements – not recommended)
- Change in owner equity due to market valuation of assets (adds certain degree of bias)

Contributed Capital and Retained Earnings

1. Net income or loss after taxes
2. Withdrawals for family living or personal investment
3. Additions of capital from gifts, inheritance, personal assets, etc.
4. Distribution of capital, dividends or gifts

Personal Net Worth

Affects only market value measure

Change may result from:
- Change in market valuation of personal assets
- Consumption of personal assets
- Investments into personal assets
- Transfer of wealth to/from outside sources

Valuation of Equity

Effect only market value (not cost value) measure of owner equity

Change in owner equity is due to market valuation changes (appreciation/deprecation) as reported on the balance sheet

Why is Statement of Owner Equity Important?

- Change in owner equity is a key indicator of financial progress (or regress)
- Statement identifies how and why change in owner equity occurs
- Reconciles statements to verify accuracy
- Shows impact of family living withdrawals and market value changes (inflation, deflation, etc.)

Unreconciled Differences in Owner Equity

Does calculated = reported?

Yes – no problem!

No – small problem or BIG problem; Use rule of materiality
- If material – try to find problem – family living is often suspect
- Forget about a $200.00 error
Cash Flow Budget

- An estimate of all cash receipts and expenditures for a defined period in time.
- Estimates can be made monthly, bimonthly, or quarterly.
- Can include nonfarm income and expenditures as well as farm items.
- Cash flow budgeting looks only at money movement, though, not at net income or profitability.

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